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Financial Markets

Irving Trust

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This afternoon, the Federal Reserve announces new definitions of the broad money aggregates M2 and M3; next Wednesday, Chairman Volcker goes before the Senate Banking Committee to lay out money and credit policy for the year ahead. What policy options exist and what policy will likely emerge? First, the near-term economic significance of the redefinition of the aggregates is negligible. As the Fed has not indicated that there will be a redefinition of M1, the market will not have a more credible week to week gauge by which to judge the Fed's likely policy response. However, if the Fed can construct a slower growing M2 (which otherwise would grow at a 35% annual rate in January), market psychology might be improved. If one monetary aggregate were not growing at an outrageous pace, the Fed might be seen as having scope to move interest rates (down!). In fact, the Fed's actual policy choices are bleak.

The Fed is, in some sense, caught between the dogmas of those who are monetarist and those who are not. The bond market has behaved as monetarists say it should in response to a surge in money growth, with yields backing-up after the last discount rate cut. M1 has grown at a 12% annual rate over the last six months; 15½% over the last three months. In this view, surely inflation is on the way. Nonmonetarists point to high nominal interest rates relative to current and forecasted rates of inflation. The economic recovery is only incipient and must be treated gently; this is not the time to raise interest rates, in this view. M1 velocity has shifted down sharply. Because of this and because it is unlikely that velocity will soon shift all the way back up, inflation (and the already rapid money growth) is not now to be so feared, the nonmonetarists argue.

In this environment the Fed must propose a credible, flexible monetary policy. The velocity issue is central. Setting policy involves forecasts of real GNP, inflation, and interest rates. Numerous forecast iterations are required before a "consistent" forecast is produced. Out of the process come various recommendations for money growth depending on velocity behavior. A policy course is selected by the FOMC, and the money growth target (primarily M1) is used to set a path for nonborrowed bank reserves. That path becomes the operating instrument of the Fed, subject to seasonal influences and some discretion.

The problem here is clear. Velocity behavior has been erratic and is almost impossible to predict. A wrong guess could leave us with a monetary policy much more contractionary than intended or much more expansionary. Indeed, this is why M1 was abandoned in October of last year. The Fed could propose much broader growth ranges for the aggregates, but this would lack credibility on inflation. Also, velocity has been so erratic that even such a policy might not be flexible enough. Shift adjusted aggregates, to allow for the new bank accounts, suffer from the same drawbacks. Instead, the Fed might emphasize more a broad money or credit aggregate. Another viable option would be to target M1 as usual with some specific stipulation as to how velocity behavior might alter the Fed's reactions to excessive (deficient) money growth. All in all a more discretionary and less rules-oriented policy is inevitable. The Fed can neither afford another bad miss of its yearly money targets nor to hit its targets at the expense of choking off recovery.

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Market Yields

	2/11/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	16.50%
Effective since	1/11/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	8.50	8.38	15.88
Repurchase Agreements	8.38	8.38	15.00
U.S. Treasury Issues			
Bills			
3 months	8.39	8.50	14.73
6 months	8.66	8.84	15.06
1 year	8.93	9.09	14.89
Coupons			
2 years	9.64	9.80	14.91
4 years	10.10	10.27	14.74
7 years	10.61	10.84	14.62
10 years	10.78	10.99	14.65
Long Bond	10.87	11.10	14.47
Negotiable Certificates of Deposit-Secondary Market			
1 month	8.30	8.45	15.30
3 months	8.50	8.70	15.50
6 months	8.70	9.00	15.50
1 year	9.20	9.40	15.60
Banker's Acceptances			
1 month	8.30	8.50	15.35
3 months	8.45	8.70	15.50
6 months	8.70	9.00	15.55
Eurodollar Deposits			
1 month	8.78	9.00	16.00
2 months	9.00	9.19	16.13
3 months	9.13	9.31	16.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.38	8.50	15.25
1 month	8.38	8.50	15.13
3 months	8.38	8.38	14.50
Bank Holding Companies			
1 month	8.00	8.00	14.50
Dealer Placed:			
3 months	8.49	8.43	15.30
New AA Corporate Utility Bond	12.40	12.60	17.13
Tax Exempt			
6 month Project Notes	4.45	4.50	8.00
1 year AAA Bond	5.00	5.00	7.90
5 year AAA Bond	6.25	6.25	8.90
20 year AAA Bond	8.90	8.80	12.10

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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